Internal Revenue Service

memorandum

CC:TL:Br3
SWIanacone
TL-N-6988-89

date: JUN 30 1989

to: District Counsel, Cincinnati, Ohio C:CIN
Attention: Carolyn M. Smith

from: Assistant Chief Counsel (Litigation)

subject: [redacted]

This is in response to your request for formal technical advice dated May 15, 1989. As indicated in your memorandum, the case is scheduled for trial on [redacted] in [redacted].

ISSUE

Whether the petitioners are entitled to a deduction for payments made to the Democratic Party from fees they received as deputy registrar in light of I.R.C. § 162(c)(2).

CONCLUSION

For the reasons stated below we do not believe the deductions can be denied under I.R.C. § 162(c)(2) or on public policy grounds. However, we recommend that the petitioners be put to the burden of proving that the deductions are ordinary and necessary business expenses allowable under § 162(a).

FACTS

According to your memorandum, in [redacted] the taxpayers were selected to serve as deputy registrar for [redacted], Ohio. The deputy registrar, a political appointee, sells license plates and renewal stickers on behalf of the state. The registrar receives $1.50 for each license sold. Of that amount, petitioners paid [redacted] cents to the Democratic Party.

The taxpayers deducted $[redacted] for these payments in [redacted] for the [redacted] months they served as deputy registrar. They characterized the payments as commissions. In [redacted] and [redacted], rather than including the [redacted] cents in gross income and deducting it as commissions, they failed to include the amounts in income. The adjustment to income for [redacted] is $[redacted] and $[redacted] for [redacted]. These three tax years are scheduled for trial on [redacted].

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Taxpayers argue that this [redacted] cent fee is deductible because it is an ordinary and necessary business expense. They feel that if they did not make these payments to the political party they would lose the position. Neither their contract with the State of Ohio nor the provisions of the Ohio Revised Code require the payments.

It is the Appeals Officer's opinion that the payments to the Democratic Party are voluntary and do not qualify as ordinary and necessary business expenses. Although nothing in writing has been presented that actually required these payments, it appears they are regularly made to the party by all deputy registrars. There's some evidence to suggest that if the payments are not made the deputy registrar contract would not be renewed. The Ohio Revised Code has recently been amended to make these payments illegal.

DISCUSSION

Section 162(a) of the Code provides that there shall be allowed as deductions, all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(c)(2) of the code denies the deduction for certain illegal payments.1/ The statutory language in question is as follows:

> (2) OTHER ILLEGAL PAYMENTS. - No deduction shall be allowed under subsection (a) for any payment other than a payment described in paragraph (1) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business.

This language was added to § 162 by section 902 of the Tax Reform Act of 1969 and was amended by section 310 of the Revenue Act of 1971. It is our position, that bribes and kickbacks must, like "other illegal payments," violate federal or state law to trigger disallowance under I.R.C. 162(c)(2). See G.C.M. 36671, [redacted] (March 30, 1976).

1/ There is no indication that the payments by petitioners involved Medicare or Medicaid and we do not believe that the Democratic Party is either a government official or employee. Therefore, our discussion is limited to the denial of deductions under § 162(c)(2), "Other Illegal Payments."

Treasury Regulation § 1.162-18(b)(1) states:

> (b) Other illegal payments - (1) In general. No deduction shall be allowed under Section 162(a) for any payment... made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under the laws of the United States (as defined in paragraph (a)(4) of this section) or under any state law (but only if such state law is generally enforced), which subjects the payer to a criminal penalty or the loss (including a suspension) of license or privilege to engage in a trade or business (whether or not such property loss is actually imposed upon the taxpayer).

Treas. Reg. § 1.162-18(a)(4) defines United States law in the context of I.R.C. § 162(c)(1). Treas. Reg. § 1.162-18(b)(1) makes that definition applicable to § 162(c)(2), but that section of the regulations also repeats the statutory language in § 162(c)(2). The explicit standards set forth in § 162(c)(2) and repeated in Treas. Reg. § 1.162-18(b)(1) are a further limitation on the definition in Treas. Reg. § 1.162-18(a)(4). Although a deduction for payment may be disallowed under § 162(c)(1) if United States law would have provided a civil penalty for such a payment, a deduction for a payment may be disallowed under § 162(c)(2) only if the civil penalty involved is the loss of license or privilege to engage in a trade or business. In other words, a criminal penalty for a payment will trigger disallowance under both §§ 162(c)(1) and 162(c)(2), but a smaller range of civil penalties will trigger disallowance under § 162(c)(2) than under § 162(c)(1).

It appears unlikely that we could show that the payments from the petitioners to the Democratic Party are the type included in § 162(c)(2). The facts of your request indicate that although Ohio has recently amended its Revised Code to make these payments illegal,2/ there is no indication that they were illegal at the time they were made. Moreover, if we intend to challenge the deductions under § 162(c)(2), we must bear the burden of proof to the same extent we would under I.R.C. § 7454, concerning the burden of proof when the issue relates to fraud. Since the burden in this case would be one of clear and convincing as opposed to a preponderance of the evidence, we do not think we would be successful in challenging petitioners' deductions under § 162(c)(2).

2/ It would be useful to know whether this was merely a codification of the common law interpretation of these payments or to in fact make them illegal.

We also analyzed the possibility of denying petitioners' deductions on public policy grounds. However, we do not believe there is a basis for challenging the deductions on these grounds. In G.C.M. 36665, the Service concluded that the judicial public policy doctrine under I.R.C. § 165 was not limited by the qualification of that doctrine under I.R.C. § 162, but that a business expense deduction under I.R.C. § 162 can be denied on public policy grounds only if it is described in § 162(c), (f) or (g). The position of the Service in G.C.M. 36665 to limit the scope of the public policy doctrine under § 162 and the related provisions of code § 61, 212 and 471 conforms to the decisions made in connection with amendments made to Treas. Reg. § 1.162-1. Treas. Reg. § 1.162-1(a) now provides:

> A deduction for an expense paid or incurred after December 30, 1969 which would otherwise be allowable under section 162 will not be denied on the grounds that allowance of such deduction would frustrate the public policy. See § 162(c), (f) and (g) and the regulations thereunder.

The regulatory language quoted above is unequivocal in limiting the public policy doctrine under § 162. The decision to adopt such limitations is supported by clear expressions of congressional intent. In 1969, the Senate Finance Committee reported:

> The qualification of the rule denying deductions for payments in these situations which are deemed to violate public policy is deemed to be all-inclusive. Thus, public policy generally will not be deemed to be sufficiently clearly defined in other circumstances to justify disallowance of deductions.

S. Rep. No. 91-172, 91st Cong. 1st Sess. 274 (in 1969).

In 1971 Congress again addressed the problem of illegal payments and provided that successful criminal prosecution would no longer be a prerequisite for denying a deduction. The Senate Finance Committee stated:

> The committee has become concerned that these provisions [§ 162(c)] enacted in 1969, may in some cases unduly restrict the denial of deductions. * * * The committee continues to believe that the determination of when a deduction should be denied should remain under the control of Congress.

S. Rep. No. 92-437, 92nd Cong. 1st Sess. 72 (1971).

These excerpts from the legislative history show that

Congress, by enacting the public policy provisions under § 162, specifically intended to preempt, at a minimum, § 162 public policy deduction disallowances. We believe that Treas. Reg. § 1.162-1(1), as amended, correctly implements the purpose of Congress and that the judicial public policy doctrine, as it existed under § 162 before 1969, no longer has any applicability to § 162 business expense deductions.

This leaves us with the question of whether these payments may be disallowed on the grounds that they are not "ordinary and necessary" expenses under § 162(a). The disallowance of such "legal" expenses is not dependant on the public policy doctrine or § 162(c), but rather on whether such expenses are ordinary (common, usual, customary or noncapitol), and necessary (appropriate and helpful). We believe that a business expense must meet the ordinary and necessary requirement to be deductible under § 162. If the Service determines that such expenses are not "ordinary and necessary," we think the petitioners should be put to the burden of proving that payments to a political party were the type of expenses that businessmen in petitioners' type of business customarily incur in their dealings. Compare Tooke v. Commissioner, T.C. Memo. 1977-91 (Denial of business deduction for bribes paid to county officials because of failure to establish that bribery was customary within petitioner's line of business) and Rev. Rul. 71-449, 1971-2 C.B. 77 (Contributions made to a political candidate or party are not deductible as business expenses under any circumstances) with Bertolini Trucking Co. v. Commissioner, 736 F. 2d 1120 (6th Cir. 1984) (Subcontractor was allowed deductions for lawful kickbacks made to primary contractor, where subcontractor understood that it would not be allowed to continue work and would not be timely paid) and Conway Import Co., Inc., v. U.S., 311 F. Supp. 5 (E.D.N.Y. 1969). 3/

3/ Although not raised in your request, an additional question which petitioners might raise for the two later years is whether these amounts were even includible in income. See Paramount Finance Co. v. U.S., 304 F. 2d 460 (Ct. of Cl. 1962); Pew v. Commissioner, T.C. Memo. 1961-264; and Rev. Rul. 77-243, 1977-2 C.B. 57.

CONCLUSION AND RECOMMENDATION

It is our position that the deductions in question cannot be denied on basis of either I.R.C. § 162(c)(2) or public policy grounds. However, we recommend that the petitioners be forced to carry their burden of proof that the amounts either are not income to them or were ordinary and necessary expenses of a trade or business carried on by them. If we can be of further assistance please contact Steven W. Ianacone at FTS 566-3407.

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